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While continuing to evaluate numerous, diverse recommendations, Gov. Luis Fortuño is

Taking charge!

- ✓ Issuing $4 billion in bonds to lift the economy ***NOW***
- ✓ Cutting $1.2 billion in government spending
- ✓ Raising $1.2 billion in new revenue

By Carlos Márquez & José L. Carmona

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Two-thirds of Puerto Rico voters satisfied with election results

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‘To do nothing is not an option’

Administration will study Economic & Fiscal Reconstruction Advisory Council’s recommendations but declares ‘state of fiscal emergency,’ warning government is on the brink of bankruptcy; quickly submits legislative package

BY CARLOS MÁRQUEZ & JOSÉ L. CARMONA
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The Economic & Fiscal Reconstruction Advisory Council (Caref by its Spanish acronym) last Thursday presented Gov. Luis Fortuño its full report and recommendations to immediately tackle the fiscal crisis affecting the Puerto Rico government.

In short, the private-sector advisory council, led by Popular Inc. Chairman Richard Carrión, recommended to Gov. Luis Fortuño to cut $1.2 billion in government spending, raise $1.2 billion in new revenue and issue $4 billion in bonds to jump-start the economy now.

The report also outlines a plan to eliminate within the next four years a $3.2 billion government deficit. Caref is expected to present more recommendations on economic reconstruction by March 31.

“The cost of not doing anything would spiral Puerto Rico into an economic depression of immeasurable proportions; that isn’t an alternative,” Fortuño said.

Coincidentally, at about the same time Fortuño and Carrión were divulging the Caref report to the press, U.S. President-elect Barack Obama was talking about his reinvestment and restoration plan on the federal level, saying “the consequences of not doing anything or very little would take us to an even greater loss in terms of jobs, income and trust in our economy.”

“On behalf of the advisory council members, I would like to thank the governor for the trust he put in us. There are many people who have expressed that this council is composed of rich people, that it only represents one sector. To my understanding, the governor selected the people who make up this council, not to represent a particular sector, but to contribute certain particular knowledge, to provide ideas and suggestions on how to face the fiscal crisis and how to direct our economy’s future growth,” Carrión said.

The report was submitted by the 14-member Caref, led by Richard Carrión, chairman, president & CEO of Popular Inc., Puerto Rico’s largest financial institution, and gathered leading experts and professionals who studied the government’s finances over the past two months in a multisector effort.

According to the report, there are only three

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ways to bridge the gap between expenses and revenue in the government's budget: increase revenue, reduce spending or finance the deficit.

The latter is only available in a limited way since it must be accompanied by revenue increases and spending reductions. Pretending to finance the deficit without the additional measures would result in a credit downgrade with catastrophic repercussions. In addition, the financial market's present situation and Puerto Rico's poor credit rating limits the use of this alternative.

The recommendations pursue four objectives: have a balanced budget for fiscal year (FY) 2012, reduce government spending, increase recurrent government revenue and fairly distribute the cost of measures among all sectors of the economy.

The magnitude of the government's budget deficit—estimated by Caref to be $3.2 billion—and the critical cash-flow situation require immediate measures that can produce a substantial impact in increasing government revenue and decreasing government expenditures during the next four years.

"We feel we are representing Puerto Rico, and part of our task is to ensure that what we are recommending is best for Puerto Rico and not to a particular sector. Here are three former presidents of the Government Development Bank under different government administrations, a former Treasury secretary, a former Treasury deputy secretary for internal revenue and several other very qualified professionals. None of us feels we're representing the private sector, the banking sector, the CPAs or the legal profession. Having said that, I believe the governor's decision three weeks ago to ask us to meet with different sector representatives of the island's economy was a good one. For us, these meetings were extremely positive. We listened to very good ideas that we believe improved some of our original recommendations to face the fiscal crisis. Some were modified, others were eliminated and other ones were adopted," Carrión added.

"The guiding principle of this economic- and fiscal-reconstruction plan is that every Puerto Rican, and I emphasize every Puerto Rican, has to do his or her part, so together we can move our economy forward and overcome this crisis. As part of this joint effort by all Puerto Ricans, those with more resources will have to contribute more, and those with fewer resources will contribute less," Fortuño said.

A local three-year recession, a one-year recession in the U.S., a global financial and economic crisis and the enduring habit of the Commonwealth government to spend more revenue than it receives and use nonrecurrent revenue and financing mechanisms to pay for recurrent expenses have all combined to put government finances in a critical situation, which requires extraordinary, severe and immediate measures to face the situation.

Contrary to earlier speculation, the proposals submitted by Caref to reduce expenses don't include a reduction in the government workweek and the proposals to increase revenue don't include an increase in the local Sales & Use Tax (IVU by its Spanish acronym).

The Economic & Fiscal Reconstruction Advisory Council led by Popular Inc. Chairman Richard Carrión, recommended to Gov. Luis Fortuño to cut $1.2 billion in government spending, raise $1.2 billion in new revenue and issue $4 billion in bonds to jump-start the economy now.

Other recommendations, such as a higher surtax on gasoline and a new tax on cellphone calls, drew immediate fire.

The magnitude of the budget deficit and lack of government liquidity requires immediate actions that could produce a substantial increase in revenue and a reduction in expenses. Some of the recommendations are temporary measures to urgently address the government's General Fund cash flow and lack of liquidity. The permanent measures have as an objective to permanently address the government's structural deficit.

"There are a series of temporary and permanent measures. On the side of the temporary measures, aimed at the corporate sector, we are proposing a two-year moratorium on several tax credits granted through different laws. Also included in the proposal is an additional 5% surtax on corporations. On the side of individual taxpayers, we are also recommending an additional 5% income tax on the gross adjusted income of those individuals who earn more than $100,000 a year," Carrión said.

The governor emphasized that at this point those are only recommendations and he would immediately submit the report to the Planning Board so it can conduct a macroeconomic study on the impact of the different actions recommended by Caref.

It is what it is

"Everybody is clear that the deficit for FY '09 amounts to $3.2 billion. There's no way to question this and, unfortunately, that's how much the deficit is. I wish it were less, but that's the number. Therefore, we must take measures to guarantee that we move forward, that we can overcome this crisis and make the economy grow once again. For that to happen, we must take immediate measures," Fortuño added.

"What we're trying to achieve here is for the economy to grow for the first time in three and a half years, to have a balanced budget and achieve a big investment in infrastructure. To do nothing ties our hands and would lead us to what happened to Detroit, which had its bond rating downgraded to junk status. If we don't act, we won't be able to move our economy forward and create jobs. We are reversing this crisis," Fortuño said.

He said a series of immediate changes had to be established to put some of the proposals found in the report into action. Among them, Fortuño signed an Executive Order declaring a "fiscal state of emergency" to reduce government spending (nonpayroll-related) by 10%. To cover this month's government payroll of approximately $450 million and pay government suppliers their more than $750 million in past-due accounts, the Legislature was expected to approve earlier this week a Government Development Bank (GDB) loan to the Treasury Department.

"I'd like to thank the efforts of advisory council members, who have been working very hard over the past two months, first to present a clear picture of the Puerto Rico government's fiscal situation and, second, perform a complete detailed analysis of the measures that will move the island economy on a path to progress, with a balanced budget over the next three years," Fortuño said.

"All who are aware of the situation recognize that the worst thing we could do in a recessionary environment is increase taxes or reduce government expenditures. The reality is that we must aim our efforts at structural problems. For many years, we have been spending more than we collect, and we have exhausted our credibility in a

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credit market that is getting increasingly more difficult," Carrión said.

CREDIT-RATING CONCERNS

"We are on the borderline, where our credit rating is one step from falling into junk status, and that's why we must take these measures, because to do nothing isn't an option. During the next week, the council will be working on the third part of the report, which is economic restructuring. That's where we expect to have recommendations to put an end to this deficit. Also during next week, we will have a much clearer picture of the economic policies of the Obama administration and how these could affect Puerto Rico," the governor added.

"On the expenditure side, there are temporary and permanent measures. Among the temporary measures, we are recommending a two-year moratorium on the economic clauses in the collective-bargaining agreements. This action would delay by two years the impact of those increases on the General Fund," Carrión said.

"Among the permanent measures, we are recommending a limit on spending at ASES [the Health Insurance Administration]. The cost increases at ASES are one of the problems that most affects the central government's fiscal health. We have proposed a series of measures to ensure benefits are provided in the most efficient way possible by offering them to those who really are medically destitute," Carrión said.

The advisory council is also recommending personnel reductions through a hiring and contracting freeze, a ban on the creation of new positions and the layoff of some 11,000 government workers illegally hired since July 1, 2008. The law bans such hiring during an election year.

There are other measures to reduce expenses, aside from payroll spending, aimed at improving efficiency in the executive branch through reorganization. The report says these could achieve savings of approximately $200 million a year.

In terms of financial measures, given the conditions of the financial markets, there's very little latitude. However, Caref believes transactions can be achieved to face the cash-flow shortfall during the first two years.

Fortuño highlighted that the plan is going to require sacrifices from everyone, but will take the government to a balanced budget in three years. "I think it's important to point out and put into context why we're doing this. Puerto Rico is going through the worst fiscal and economic crisis since the Great Depression. Last week, Detroit had its general obligation bonds (GOs) degraded to junk status (noninvestment-grade.) This means Detroit won't be able to build new schools, roads or bridges. There will be no money for public works projects because they won't be able to go to the financial markets. Puerto Rico can't afford to run the same risk as Detroit," Fortuño said.

"This plan, which we will now analyze in depth, eliminates the deficit in four years and, I emphasize, without touching workers' hours or increasing the IVU. I know there were numerous comments about both issues, but neither one of them is involved; however, we still achieve our goal to balance the budget and place Puerto Rico on the path for big economic growth.

"That's why I'm acting immediately to ensure we begin to solve the deficit problem and stimulate the economy through a *criollo* stimulus plan. Tomorrow [Friday], we will be talking more about this *criollo* economic-stimulus plan, which will go hand in hand with the federal stimulus plan but, as I have said in the past, we aren't waiting for the federal plan. Here, we have to solve our problems ourselves," the governor added.

"However, there are measures we need to take immediately. I'm going to sign my first executive order declaring a fiscal state of emergency, something similar to what the governor of California did just a few months ago. This initiative [executive order] is in tune with measures already taken by many other states, not just California, and allows for the immediate implementation of a management-prudence plan in all government agencies. It is aimed at reducing government operational expenses by 10%. The executive order requires an immediate hiring freeze on all new employees, prohibits the creation of new posts and eliminates vacancies so these positions can't be filled. In addition, on the first day of the new legislative session, we will be presenting the first set of legislative measures to implement the economic and fiscal reconstruction plan we have been talking about," he said.

"First of all, we are assuring the payroll for all government employees. Their payroll checks will be guaranteed. Secondly, the government owes more than $750 million to private-sector suppliers, including nonprofit organizations. We are going to pay them. This is an immediate injection of money into the economy that we're going to achieve by implementing these measures," Fortuño said.

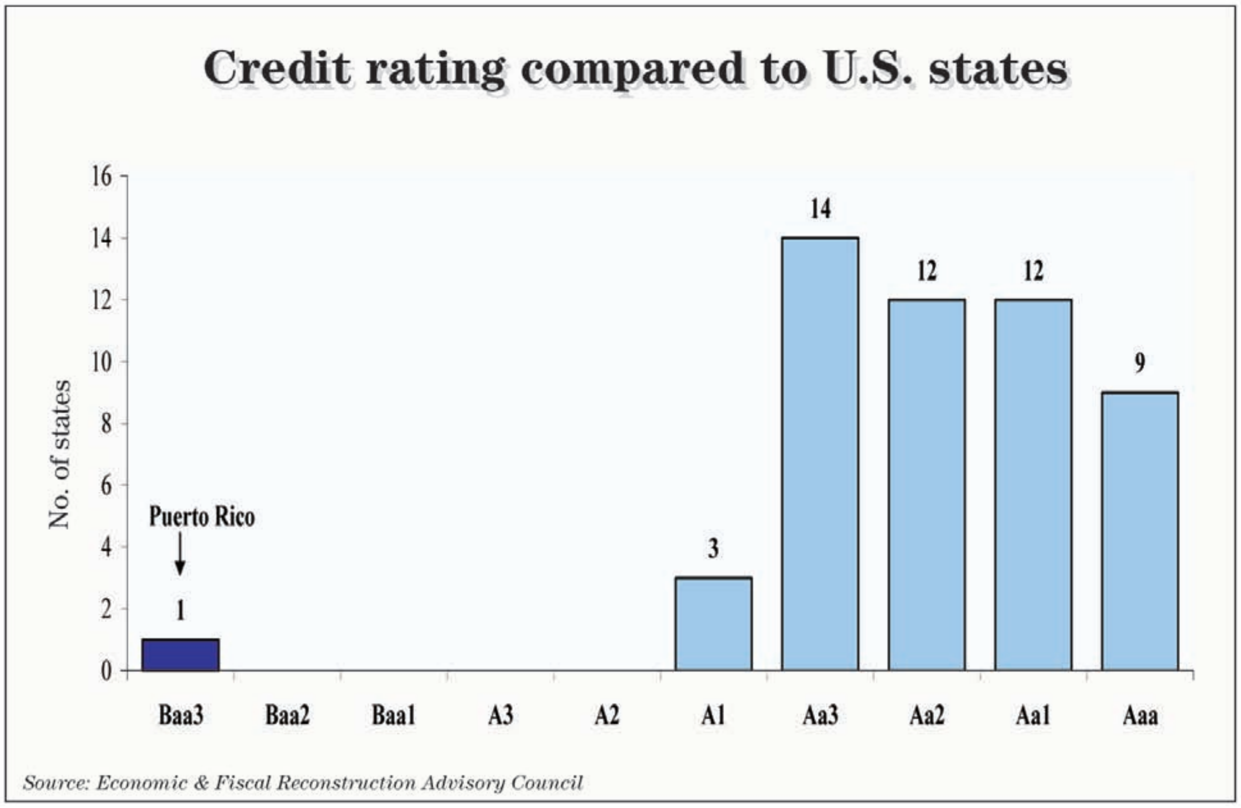
"The legislative bills, to be presented immediately, are going to once again stimulate the economy and allow the financing of part of the *criollo* economic-stimulus plan, expected to include measures to help small and midsize businesses, as well as provide relief to local consumers. There are some spending-control measures we knew we had to take, which are contained in the report and, as a direct consequence, we immediately included them through the executive order. There are others, however, that will require quick but deep analysis to make sure we understand their macroeconomic impact," the governor explained.

The stateside recession was brought about through the financial crisis and lack of regulation in certain markets and industries, and it's up to the federal government to regulate those issues that caused the crisis. As for Puerto Rico, where the island has been in a recession three years before the rest of the nation, it was the local government, the governor said, that was at fault for spending more than what it had, year after year.

The governor added that the government can't continue to function as it has. Closing the government and sending public employees to the streets isn't an option.

"The period of careless spending is over. We must have a balanced budget and we need to make sure we have the necessary conditions for job creation in Puerto Rico, and that's what we're going to do," Fortuño said.

When you're the federal government, you can print more money as needed. Therefore, it can print billions of dollars and distribute the money among the states and territories like the president is going to do. Here, we don't print money, although we welcome it with open arms. We must be clear that it's the governors in each state who have to live within the budgets they have, while the federal government can splurge a little more because it prints its own money. ■



Source: Economic & Fiscal Reconstruction Advisory Council

Richard Carrión: 'We achieved something that is good'

Economic & Fiscal Reconstruction Advisory Council chairman talks about the group's challenges to complete its report

BY JOSÉ L. CARMONA
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On Nov. 10, 2008, Gov.-elect Luis Fortuño selected 14 prominent figures from the private sector (and some with prior public-sector experience) to create the Economic & Fiscal Reconstruction Advisory Council.

The group, headed by Popular Chairman, President & CEO Richard Carrión, was given three main tasks: set the ground rules for the development of public-private partnerships or PPPs, present recommendations to fix the government's dire fiscal crisis as well as submit proposals to jump-start the island's three-year-old recessionary economy.

Apart from Carrión, the council includes such known figures as Grande Supermarket President Atilano Cordero Badillo; former Hacienda Secretary Xenia Vélez; former Hacienda Deputy Secretary Teresita Fuentes; Ballester Hnos. President Alejandro Ballester; Deloitte & Touche Partner Gilberto Del Valle; Ernst & Young Partner Rodolfo Colberg; Universal Group CEO Luis Miranda Casañas; attorney Manuel Pietrantoni; Merck Vice President Daneris Fernández; Desarrollos Urbanos President José Vizcarrondo; and three former Government Development Bank presidents under different administrations—José Ramón González, Marcos Rodríguez-Emma and William Lockwood.

The advisory council originally had until Dec. 15 to submit its report with the group's recommendations to fix the $3.2 billion budget deficit. The group delayed delivering the report on possible solutions because the situation was found to be far worse than what had been reported when work began.

"When we received the reports from the agencies about their fiscal situation, we found the problem was much worse than any of us had originally envisioned or anticipated. To that end, we tried to determine its magnitude…and, as everyone knows, information here isn't perfect," Carrión told CARIBBEAN BUSINESS during an exclusive interview following the presentation of the report Jan. 8. "The fundamental part here was to collect the data."

Carrión said that despite the challenges in gathering the information, the group was "comfortable" with the magnitude of the problem they found—a $3.2 billion deficit.

"We aren't exaggerating it one way or the other. We basically stated the magnitude of the problem within the context of a situation that had gotten worse over time—within an external situation where the financial markets have shut their doors, and that's the reality we have to deal with," he added.

The group, Carrión noted, also spoke with several investment banks that have been working with Puerto Rico for many years, although didn't specify which ones.

"They told us about their perspective on the market. We also listened to several economists and, obviously, we utilized the inherent talent within our group and tackled the problems at hand by beginning a balance sheet reconciliation process until we reached some minor conclusions," the council chairman explained.

When the governor asked the group to seek additional input, Carrión said the council was divided into several groups. Among other groups, the advisory council met Jan. 5 with the heads of more than a dozen local labor unions, who had asked Gov. Fortuño for the meetings to incorporate their opinions on how to solve the island's economic crisis.

"We listened, then we met, we listened some more and then we met again, and we began to modify some of the proposals. I think we achieved something that is good for several reasons," Carrión commented. "First of all, it was a good thing, because we left the diagnosis out there, so the people could better assimilate the extent of the problem and the seriousness and the urgency of the fiscal crisis."

Carrión indicated he believes the process to seek additional feedback enriched the report and made it much better. "It allowed us to focus on something a little more balanced, and I believe that was very positive," he said.

Carrión said the proposal to impose an additional 5% income tax during a recession, on banks, insurance companies and corporations, isn't the most desired action, but the group had to find a balance.

"We tried our best so everyone contributes accordingly, to avoid people later saying this was too loaded on one side, and too soft on the other. It's a matter of striking a balance," Carrión noted. "Given the circumstances, I think everyone has to contribute. We can't favor one sector over another, but seek that delicate balance so everyone contributes."

The Popular Inc. Chairman, President & CEO said the group doesn't like to impose new tax measures of any kind or immediate measures to reduce government spending in the middle of a recession because that goes against all economic theories. "Nevertheless, we have to recognize the reality; we are against the wall and we must aim at a structural problem that has been in the making for many years," he concluded. ■

Estimated revenue and expenses of the impact of recommended measures fiscal years 2009-2013 (in millions)

	Budgeted 2008-09	Projected 2008-09	2009-10	2010-11	2011-12	2012-13
A. Revenue						
1. Budget revenue (basis)	$8,488	$8,488	$8,488	$8,488	$8,488	$8,488
2. Change in recurrent revenue (excluding IVU and pharmaceutical companies)		($410)	($282)	($19)	253	537
3. Change in IVU collection allocation		($77)	($59)	($22)	16	56
4. Pharmaceuticals			($8)	($30)	($165)	($246)
5. Reduction in rum excise tax rebate				($120)	($120)	
6. Estimated impact of tax credits		($200)	($200)	($200)	($200)	($200)
Subtotal	**$8,488**	**$7,801**	**$7,939**	**$8,216**	**$8,272**	**$8,515**
B. Expenses						
1. Budgeted expenses	$9,484	$9,484	$9,484	$9,484	$9,484	$9,484
2. Inflationary impact on budgeted expenses		$0	$34	$69	$72	$75
3. Impact of collective bargain agreements		$0	$276	$290	$305	$320
4. ASES deficit		$500	$640	$790	$950	$1,122
5. Other deficits		$100	$100	$100	$100	$100
6. Increase in debt service payments		$115	$340	$340	$340	$340
7. Increase in debt payments to GDB		$50	$100	$100	$100	$100
Subtotal	**$9,484**	**$10,249**	**$10,974**	**$11,173**	**$11,351**	**$11,541**
C. Annual operational deficit	($996)	($2,448)	($3,035)	($2,957)	($3,079)	($3,026)
D. Interagency and third-parties' accounts payable		($750)				
E. Budget deficit	($996)	($3,198)	($3,035)	($2,957)	($3,079)	($3,026)
F. GDB loan based on tax debts	$996	$1,000	$0	$0	$0	$0
G. Cash flow deficit		($2,198)	($3,035)	($2,957)	($3,079)	($3,026)
H. Recommended revenue measures						
1. Temporary						
a. Suspension of tax credits		$0	$200	$200	$150	$150
b. Surtax of 5% on corporations		$0	$30	$30	$0	$0
c. Surtax on personal income & property		$16	$228	$213	$36	$0
d. Revision of exemption on real estate property		$0	$144	$144	$0	$0
e. Tax on cellular phone calls		$46	$176	$167	$159	$0
Subtotal of temporary measures		**$62**	**$778**	**$754**	**$345**	**$150**
2. Permanent						
a. Gasoline tax		$66	$262	$262	$262	$262
b. Cigarette tax		$15	$50	$45	$40	$35
c. Alcoholic beverages		$10	$30	$30	$30	$30
d. Voluntary tax compliance and improve oversight		$200	$30	$31	$31	$32
e. Improve captation of Sales & Use tax (IVU)		$19	$75	$77	$80	$84
f. Changes in the Alternate Minimum Contribution		$0	$50	$50	$50	$50
g. Changes in appraised value of real estate property		$0	$0	$0	$500	$500
Subtotal of permanent measures		**$310**	**$497**	**$495**	**$993**	**$993**
Subtotal of temporary and permanent revenue measures		**$372**	**$1,274**	**$1,249**	**$1,340**	**$1,144**
I. 1% IVU assigned to Cofina			($200)	($200)	($200)	($200)
J. Reduction of automatic formula assignments						
1. University of Puerto Rico		$0	$86	$114	$95	$81
2. Municipalities			$20	$13	$12	$7
Subtotal		**$0**	**$106**	**$127**	**$107**	**$88**
K. Expense reductions						
1. Temporary						
a. Extension on the applicability of economic clauses of collective bargain agreements		$69	$276	$290	$28	$30
2. Permanent						
a. Freeze on employee hiring		$0	$161	$317	$469	$616
b. Reduction of transitory, nonregular and trust employees		$28	$113	$113	$113	$113
c. Employee hires after the July 1 freeze		$50	$150	$150	$150	$150
d. Elimination of cash payment for vacations		$100	$100	$100	$100	$100
e. Reduction of 10% of nonpayroll operational expenses		$16	$75	$75	$75	$75
f. Reorganization of the executive branch		$0	$130	$130	$130	$130
g. Reduction of 10% of the legislative branch		$0	$13	$13	$13	$13
h. Reduction to political parties		$0	$0	$0	$0	$28
i. Revision to the assignment by formula to municipalities		$0	$105	$112	$113	$118
Subtotal of temporary and permanent expense measures		**$264**	**$1,124**	**$1,301**	**$1,191**	**$1,373**
L. Impact of revenue-raising measures and expense reduction		$635	$2,303	$2,477	$2,438	$2,405

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Economic & Fiscal Reconstruction Advisory Council's recommendations—in-depth

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In a nutshell, the Economic & Fiscal Reconstruction Advisory Council's (Caref by its Spanish acronym) recommendations can be grouped into three big categories: those meant to reduce government expenditures, those aimed at increasing government revenue and financial measures aimed at restructuring the existing government debt, among other priorities.

Increasing government revenue by $1.2 billion

• *Increase gasoline taxes.* Among the measures recommended by Caref is an increase in the excise tax on gasoline. Compared with the 50 states, Puerto Rico's current excise tax on gasoline of 16¢ per gallon (or 23¢ if the existing tax on crude oil is added) is by far one of the lowest in the nation, well below the national average of 45¢.

Even after the proposed increase, the excise tax on gasoline would still remain well below the 50-state average. This will continue to promote the prudent use of the automobile while at the same time stimulate the use and creation of mass-transit systems. Caref recommends an increase in the gasoline-excise tax from 16¢ to 40¢ a gallon and the additional difference would stay in the General Fund. Projected gasoline consumption in 2008, if the additional 24¢ per gallon is applied, could generate $262 million in revenue. Projected sales are 1.09 billion gallons.

The tax on gasoline is fundamental revenue for state governments. It has also been used to reduce gasoline consumption, encourage acquisition of more efficient vehicles and promote the use of collective transportation. The measure would increase the price of gasoline to consumers by approximately 6.5¢ a liter.

• *A $3 tax per barrel of crude.* During the past 20 years, there hasn't been an adjustment to the computation method on the crude-oil tax. As the price of oil increases, the tax is lower. The tax currently is $3 a barrel. The tax revenue has been decreasing as the price of oil increases, which has impacted the Puerto Rico Highway & Transportation Authority's (HTA) financial situation, decreasing revenue from $158 million in 1999 to a projected $99 million in 2008. The HTA gets up to $120 million a year from this tax revenue.

With an estimated consumption of 33 million barrels, the projected revenue could be an additional $99 million a year. Caref proposes that the additional revenue would stay with the HTA to partially cover the operational expenses of the Urban Train ($110 million) and its related debt service of $100 million a year.

• *A 50¢ increase on cigarettes taxes.* Caref recommends an additional 50¢ tax on a pack of cigarettes that could generate about $50 million a year in the short term. As demand decreases, the impact could also benefit the general population's health-related costs.

• *Increase alcoholic beverage tax.* An increase in the alcoholic-beverage tax (distilled spirits, beer and wine) could generate an additional $30 million in revenue. Caref further recommends that local beer production be charged with the proposed tax increase and be excluded from the 2002 exemption.

• *Two-year moratorium on tax credits.* Caref recommends a two-year moratorium on tax credits while the results are evaluated to determine if the economic activity generated merits their continuation. They further recommend eliminating those laws that allow for a possible credit for losses if economic activity isn't successful. It is estimated that approved tax credits could reach $1 billion.

The incoming Treasury secretary should give priority to establish the fiscal impact of those laws that provide tax credits and implement a reduction of at least $150 million.

According to the report, although many of these credits promote economic activity, there is no analysis of the results to verify if the credits compensate for the costs they involve. The government doesn't have a record of tax credits approved; therefore, there is no way to analyze their effectiveness or to project annual General Fund revenue. Many laws that allow for tax credits don't even have a ceiling.

Even without having all the required financial information, Caref believes the suspension of new tax credits could provide annual savings of approximately $200 million.

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Continued from previous page **Estimated revenue and expenses of the impact of recommended measures fiscal years 2009-2013**

	Budgeted 2008-09	Projected 2008-09	2009-10	2010-11	2011-12	2012-13
M. Recommendations concerning ASES						
1. Limit expenses to a percentage of recurrent revenue		$0	$60	$147	$461	$589
2. Increase in Medicaid transfers		$0	$75	$200	$200	$200
Subtotal		**$0**	**$135**	**$347**	**$661**	**$789**
N. Deficit		($1,563)	($597)	($133)	$21	$168
O. Financial measures						
1. Restructure debt service		$125	$250	$0	$0	$0
2. Changes in Prifa "escrow" account		$100	$0	$0	$0	$0
3. Lottery		$0	$350	$150	$0	$0
Subtotal		**$225**	**$600**	**$150**	**$0**	**$0**
Subtotal including financial measures		**($1,338)**	**$3**	**$17**	**$21**	**$168**
P. Fiscal stability measures						
1. 1% additional IVU assigment to Cofina and bond issuance		$1,338	$0	$0	$0	$0
Q. Potential additional measures						
1. Increase in the IVU		$0	$0	$0	$0	$0
2. Dividends from the State Insurance Fund		$0	$0	$0	$0	$0
TOTAL		**$1,338**	**$0**	**$0**	**$0**	**$0**
R. Other measures that do not impact the General Fund						
1. Increase in crude oil tax		$50	$99	$99	$99	$99

Source: Economic & Fiscal Reconstruction Advisory Council

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• *Surcharge of 5% on corporations.* As an emergency measure and so all sectors contribute to eliminating the fiscal crisis, a 5% surcharge is recommended on taxable companies. Caref estimates $30 million in additional annual revenue.

• *Surcharge of 5% to adjusted personal income in excess of $100,000.* Caref recommends a temporary 5% surtax on taxpayers with adjusted gross income of more than $100,000 for tax years 2009, 2010 and 2011. The recommendation is expected to collect approximately $65 million a year. According to data from the Treasury Department for 2006, only 2.37% of tax filings (23,906 of 1,007,057) reflect adjusted gross personal income in excess of $100,000. Filers with adjusted gross personal income in excess of $200,000 represent 0.55% of tax forms filed or 5,561 filers, but represent one-third (32.9%) of government revenue from personal income tax.

• *Changes in property taxes.* There is also a real-estate property tax on residences valued above $15,000 based on 1957 values. This additional real-estate property tax, along with a reduction in the $15,000 exemption, should affect less than 20% of the residences in Puerto Rico.

"So everyone is clear about this, a residence valued at $15,000 in 1957 is equivalent to a residence valued at $220,000 today. We are also recommending a review of the entire real-estate property-tax system over the next two years. We need to be clear that those homeowners who don't pay under the current $15,000 exemption won't be affected by these recommendations," Carrión said.

According to Carrión, this additional tax on property would go directly to the General Fund through the Municipal Revenue Collection Center (CRIM by its Spanish acronym). Second, we recommend a review of property-tax appraisals in Puerto Rico because the reality is that we haven't reviewed property-tax values since 1957. We are proposing an integral real-estate property tax reform.

According to Fortuño, an integral real-estate property-tax reform dramatically opens the door for a reduction in income taxes. This also helps to go after the tax evaders who live in a $500,000 home but report income much lower than their lifestyle. These homeowners will have to pay for what they have, even if they report a different income.

"This is something that has been discussed before. Former governors have created work groups or task forces, but no one opened the door to it. In my opinion, this recommendation opens the doors, since we will be analyzing an integral tax reform. This can't be discussed in a couple of hours. It really requires a more profound analysis, but you know I'm philosophically convinced that as the economy moves forward, people will have more control over their money. A dollar in the hands of the people goes much further than in the hands of the government," the governor added.

Caref recommends a reappraisal of real-estate property in Puerto Rico to adjust it to real values. Once the project is completed, the temporary measures regarding the revision and surtax on property-tax exemption will be abolished. Estimated revenue collection from this measure is estimated at $500 million starting in FY 2011-2012.

Based on 1.2 million homes in Puerto Rico with an average 8% interest rate and an appraised value of 20% of the properties exceeding $15,000 by an average of $7,500—in other words, appraised at $22,500—the additional revenue to the General Fund as an outcome of the reduction of the exemption and the surtax could represent an annual revenue of $288 million.

The loss in tax exemption and the surcharge eventually would disappear when real appraised values are implemented.

• *Tax on cellular phone communications.* Caref recommends a 1¢ per minute special tax on voice communication over cellphones. Assuming an average use of 700 minutes a month and 2.2 million active cellular lines, it could represent $185 million in annual revenue until FY 2012. The tax wouldn't apply to data or text messages.

• *Voluntary compliance and better oversight.* To address tax evasion and polish the system, Caref recommends taxpayers could voluntarily report and pay previously unreported income in such areas as personal and corporate income, the IVU and other appraised debt as a first stage. Once completed, the Treasury Department would institute an aggressive audit and tracking program to ensure future compliance.

Based on past experience, this measure could generate approximately $200 million during the six months left of this fiscal year and recurrent revenue of $30 million a year.

"Our new Treasury secretary [Juan Carlos Puig] has a lot of experience, precisely with the federal Internal Revenue Service. Where they have the proven mechanisms to increase tax collections, we will achieve great cooperation, so necessary on the federal, state and municipal government levels to ensure we have the right person to do what needs to be done," Fortuño said.

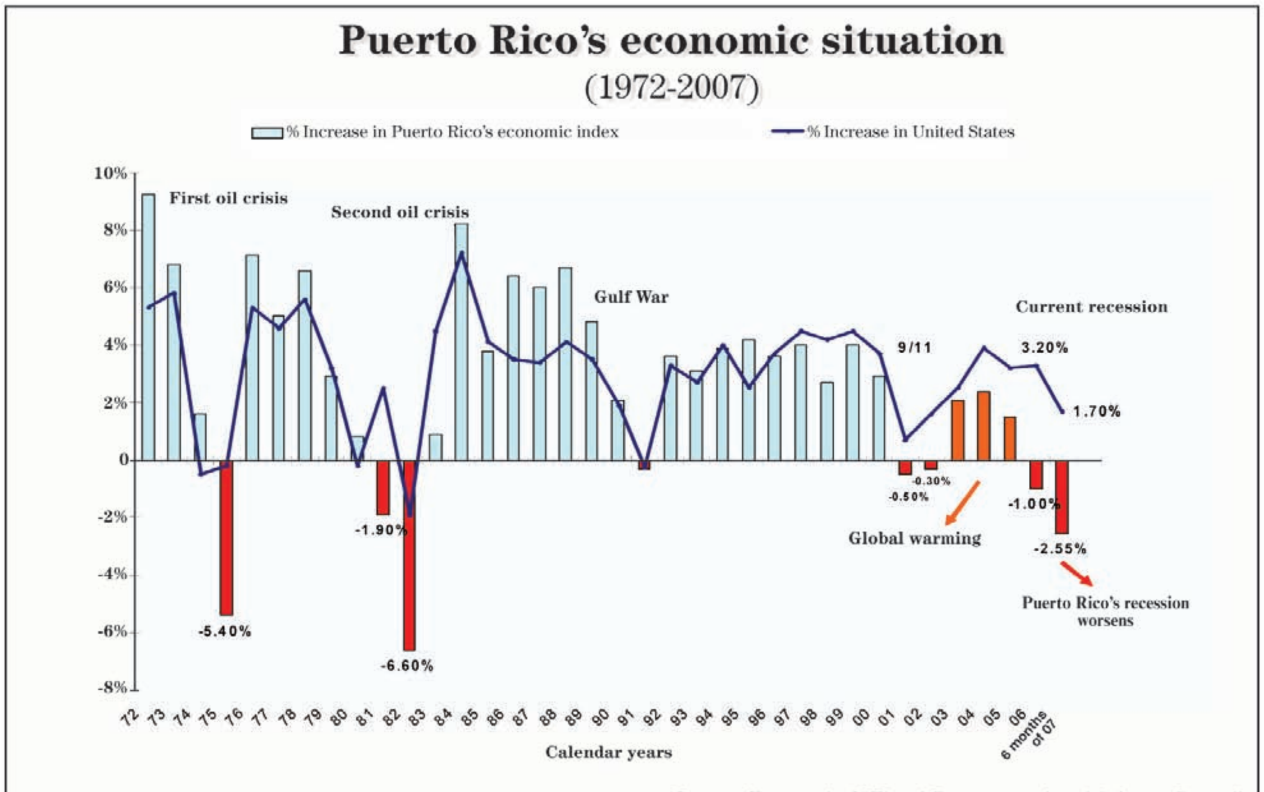
"Coincidentally, we chose correctly. The report mentions the need and desirability to put greater emphasis on the IVU collection. The number heard on the streets is about a 65% IVU collection, when the average in other jurisdictions is over 80%. In other words, many people are charging the IVU, but aren't paying it to Hacienda. That, obviously, has to change," Fortuño added.

• *Improve IVU's capitation.* Caref proposes more uniformity in IVU filings to simplify and improve filing and compliance. The Treasury Department will distribute the appropriate proportion to the municipalities. The establishment of a lottery for consumers who retain their IVU receipts will also improve compliance.

One of the mechanisms used to evade payment of the IVU is the use of resale certificates. To avoid the possibility of double taxation, a tax-credit system against IVU payments by the reseller must be implemented. These measures could provide an additional $75 million and increase to $84 million in FY 2011.

• *Increase capital-gain tax.* The advisory council also recommends an increase in the capital-gain tax to 20% for individuals and 25% for corporations and to increase the required possession period to six months. Nevertheless, Caref believes the revenue potential of this measure will be limited in the short- and midterms due to the current situation of the real-estate and financial markets.

• *Government spending-control recommendations to reduce more than $1.2 billion.* The government's structural deficit exceeds $3 billion and can't be eliminated without reducing government expenses. Government payroll represents



Source: Economic & Fiscal Reconstruction Advisory Council

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approximately 76% of the General Fund. Following are some of the recommendations to reduce government expenditures:

• *Place a moratorium on collective-bargaining agreements.* Caref recommends a moratorium of two years to implement the economic clauses of the government's collective bargaining agreements, which could represent a reduction of approximately $200 million a year.

• *"Freeze the hiring of government employees; prohibit the creation of new positions and eliminate vacant positions.* Under the assumption that out of the 179,000 central government employees, 3% either retire or change employment each year and the cost of a public employee is $30,000 a year, this measure could generate annual savings of $161 million with a cumulative increase of $616 million a year by FY 2013," the report said.

Fortuño said the law states that to honor those agreements, the government must identify the funds. The government agency heads who signed those agreements were irresponsible because they deceived the workers.

• *Eliminate 33% of transitory, irregular and trust positions.* In addition, "a 33% reduction of transitory, irregular and trust personnel in central government agencies could mean an annual expense reduction of $113 million. Transitory employees make approximately $241 million a year. Add to that the $100 million that trust personnel make and there is a total of $341 million a year," the report states.

• *Eliminate employees hired after July 1, 2008.* "In respect to the 11,000 positions to be eliminated in government, I already made some expressions to that effect. The steps we're going to take with employee contracts after July 1, 2008, six months ago, we will be announcing these in detail when we have concrete steps in that regard. We will take all the measures we need to ensure we do things correctly. I expressed myself openly about this issue on the irresponsibility of knowingly contracting people when there was no money to pay them. However, this topic has been widely discussed; they were contracted by people who knew the government had a deficit but, in due time, we're going to provide details. At this moment, I can't discuss the specifics. This will be analyzed and we will take whatever measure we need to take," Fortuño added.

According to the report, all employees hired after July 1, 2008 should be eliminated. Using an estimate of 5,000 employees in this category, and assuming an average cost of $30,000, government payroll could be reduced by $150 million.

• *No more cash payment for 'sick leave.'* Caref recommends that to face the cash-flow situation, the balance of accumulated "sick leave" time, as of December 2008, be liquidated as compensatory time.

For subsequent years, the report recommends legislation be adopted to eliminate the accumulation and liquidation of "sick leave" and vacations in excess of the respective 90 and 60 days. Government employees currently receive 30 days a year for vacations and 18 days for sick leave annually. The balance not used in a year can be accumulated for subsequent years up to a maximum of 60 to 90 days, respectively.

The excess over 90 days for sick leave, accumulated as of Dec. 31 of each year, is paid in cash during the first quarter of the next year. In 2008, the sick-leave payments to public employees amounted to approximately $104 million.

• *A 10% reduction in government operational expenses.* Out of the government General Fund budget, 70% or approximately $7 billion is assigned to operational expenses. If payroll expenses are excluded, there is $1.25 billion left, so Caref recommends, while a reorganization of the executive branch is analyzed and implemented, at least a 10% reduction in those expenses be implemented.

Among the areas to be reviewed during the next 30 days are: professional service contracts, advertising expenses, the use of official vehicles, drivers and cellphones, the acquisition of new computer programs and reduction of electricity consumption.

According to the proposal on government agency consolidation, the operational expenses of agencies not involved are approximately $750 million a year; therefore, a 10% reduction would mean a savings of $75 million.

• *Reorganization of the executive branch.* Caref recommends the consolidation of 44 government agencies that have a budget of $1.358 billion. A 10% reduction of expenses could mean savings of approximately $130 million a year. The government has 122 agencies whose functions in many cases are very similar or duplicated. In addition, it recommends a full revision of government programs by the Office of Management & Budget and the application of "zero-based budgeting" with the objective to reduce spending by an additional $126 million a year.

• *Cutting funds to the Legislature.* Caref also proposes a cost reduction at the Legislature. The Legislature receives approximately $130 million a year from the General Fund. A study conducted by MIDA in 2003 revealed the financial remuneration of legislators in Puerto Rico and the number of employees assigned are many times higher than those in state legislatures in the U.S.

Measures such as a reduction in the number of legislators and the number of individual advisers should be implemented. Nevertheless, in the short term, expenses must also be reduced by 10%, which could mean a savings of $13 million a year.

• *Political parties.* Caref also proposes a reduction of public funds used by political parties, which could reach $34 million during a four-year term. There is an allocation of $300,000 per political party in nonelection years and $7.6 million during an election year.

• *Exclusion of UPR from revenue-raising measures.* The report also proposes the exclusion of University of Puerto Rico (UPR) from allocations from any government-revenue increase beyond its average 9.6% allocation from the General Fund budget. The UPR budget for FY '09 is $873 million. Due to the reduction in revenue to the General Fund, it is estimated that UPR's average annual revenue would decrease by approximately $94 million.

• *Cut municipal subsidies by half.* Municipal governments receive 2.5% of the General Fund, plus 35% of revenue generated by the lotteries up to $26 million. For the current fiscal year, the assignment for municipalities from the General Fund amounts to $374 million.

Caref recommends—considering IVU revenue collected by the municipalities and the urgency of

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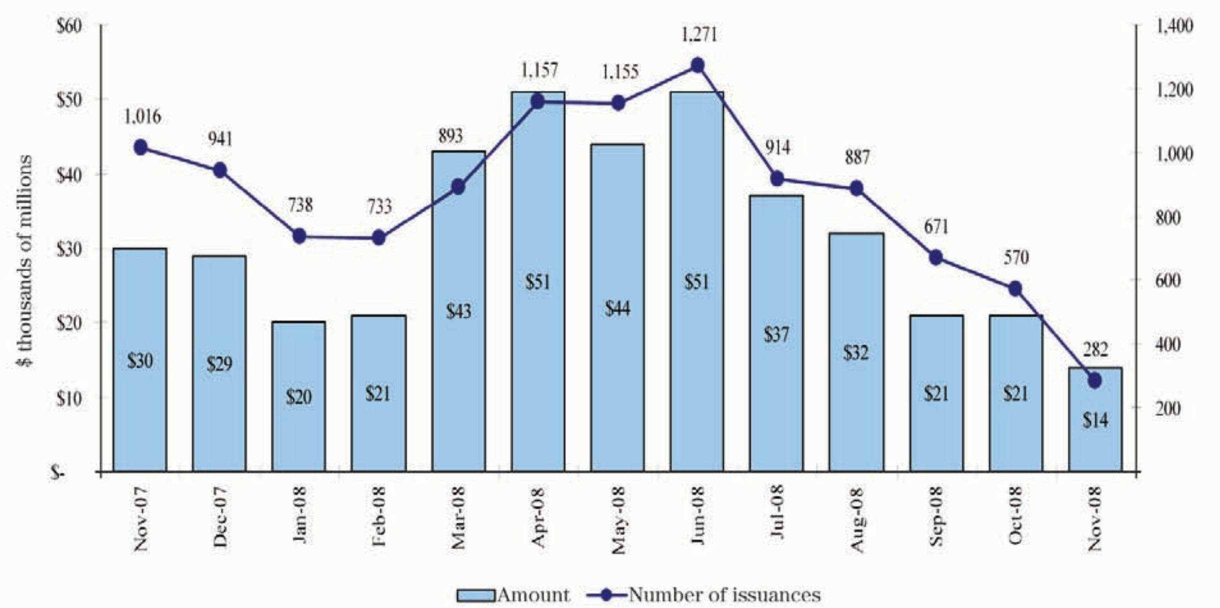
Municipal bonds market



Source: Economic & Fiscal Reconstruction Advisory Council

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the fiscal crisis faced by the Puerto Rico General Fund—that starting next fiscal year, that the general fund allocation to municipalities be reduced from 2.5% to 1.25% of the General Fund, representing annual savings of $125 million, and eliminate municipal participation in lottery revenue.

• *Judicial branch must also participate in spending controls.* The judicial branch gets a 4% budget allocation from the General Fund and, according to law, it isn't reduced if average collections are cut, as is expected to happen during the next two years. An annual 10% reduction would represent savings of $35 million a year.

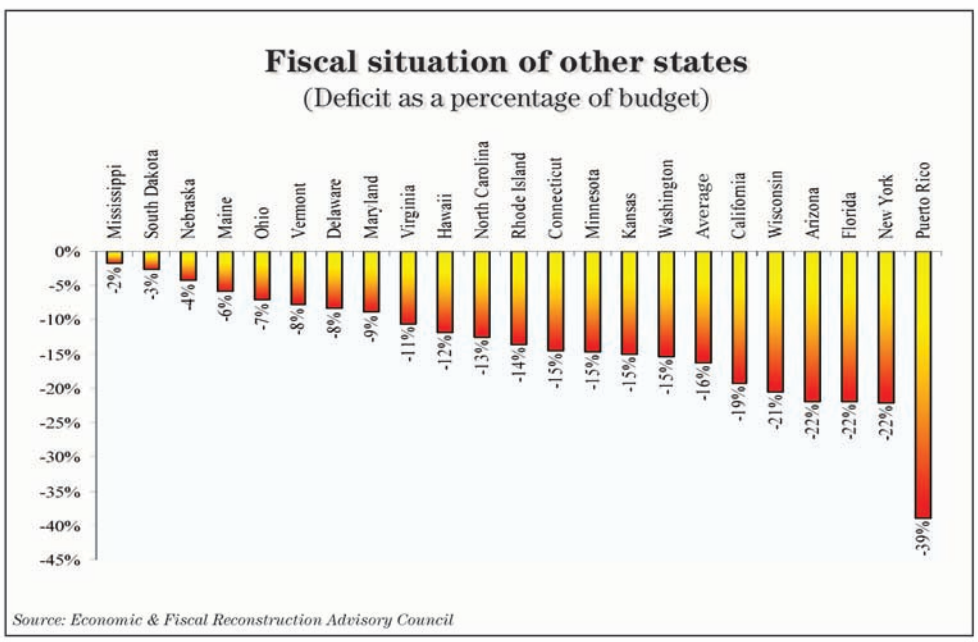
• *Tackling Health Reform.* The budget assigned to the Puerto Rico Health Insurance Administration (ASES by its Spanish acronym) must be reduced. ASES' FY '09 budget is $1.495 billion, of which approximately $1 billion comes from the General Fund, $278 million from federal funds (Medicaid) and $212 million from municipalities. If the federal government re-evaluates the current Medicaid cap and provides Puerto Rico residents with equal treatment, it could mean an additional $700 million a year.

In the meantime, ASES told the transition committee it anticipates a $500 million deficit this fiscal year, elevating the cost to provide health insurance to approximately 1.5 million people (38% of the population), at a cost of $2 billion, which is expected to increase due to the current recession.

If ASES' costs are assumed, they could increase at an annual 7% rate (which has been the recent historical increase), then the General Fund would be faced with a $1 billion deficit from this line item alone.

Caref recommends short-term actions be taken to achieve cost efficiency and reduce costs at ASES while a major structural change is implemented.

Considering the General Fund's fiscal situation, and without a guarantee of a substantial increase in federal funds, Caref recommends ASES' fund allocation be limited to approximately 20% of recurrent revenue to the General Fund.



Financial recommendations

Restructure the debt to postpone $300 million in annual debt service. The annual debt service of general obligation bonds (GOs), which is paid from the General Gund, is expected to increase from $414 million in FY '09 to $763 million in FY '10 and stay at more than $700 million a year for the next 11 years.

Subject to market conditions, Caref proposes the refinancing of GO bonds to achieve a temporary relief in debt service payable in FY '09 and FY '10. The potential savings, while central government finances are straightened out, could be $300 million a year.

There is also the possibility of restructuring the Public Building Authority, which could provide cash-flow savings of $75 million during FY '09 and FY '10.

• *Sell assets at Prifa (AFI).* Caref further recommends selling the financial assets deposited in the "Corpus Account" of the Puerto Rico Infrastructure Financing Authority (AFI by its Spanish acronym) valued at approximately $1.75 billion.

The revenue would be used to pay $1.126 billion in AFI's Special Obligation Bonds (Series 2000A and 2000B), which repayment is guaranteed by such assets; deposit $300 million in the Corpus Account with an investment contract with the GDB so the principal could grow up to $1 billion by 2040; and, from the remaining amount, use two-thirds to pay government operational expenses and the remaining third for GDB capitalization.

• *$500 million from new lottery games.* Additional short-term cash flow could be obtained by monetizing revenue from new lottery games. Using a typical financial structure for lottery games, providing four times debt service, Caref estimates $500 million could be raised to cover deficits in FY '10 and FY '11, predicated on market and credit-rating agencies acceptance. Legislative approval would be required.

Tax-relief measures

• *Work tax credit and support to pensioners.* Caref recommends the evaluation of providing a $300 work tax credit and a $300 bonus to pensioners ages 65 and older, who live under the poverty level, defined as $15,000 or less per couple.

• *Reduction of tax rates.* Although the cost hasn't been quantified, Caref believes a systemwide restructure of the tax system is necessary, particularly in the income-producing sector so it stimulates work and productive investments. Essential elements that should be included are: broadening the tax base, tax-rate reductions at all levels, evaluation of tax exemptions, credits and special deductions to analyze their effectiveness and simplify the system to facilitate compliance and oversight by the Treasury Department.

Fiscal stability measures

• *Issuance of $4 billion in Cofina bonds.* Law No. 117 of June 4, 2006 established a 7% Sales & Use Tax (IVU by its Spanish acronym). One percent is used to pay the so-called extraconstitutional debt, 4.5% goes to the General Fund and 1.5% goes to the municipalities. Then, Law 56 of July 5, 2007 authorized the creation of the Puerto Rico Sales Tax Financing Corp. (Cofina by its Spanish acronym) and the use of the 1% central government allocation of the IVU to repay the debt service on bond issuances to cover the extraconstitutional debt that was $6.8 billion as of June 30, 2006.

Based on this structure, $5.2 billion in Cofina bonds have been issued, leaving $1.6 billion in potentially eligible debt to be refinanced by Cofina bonds.

With the allocation of an additional 1% of the IVU to Cofina, it could issue up to $4 billion that could be used to refinance a substantial part of the remaining "extraconstitutional" debt, liberate funds at the GDB to increase its liquidity and lending capacity and be able to provide long-term financing of the FY '09 deficit and potentially cover costs for comprehensive fiscal reform.

The most significant of these measures is to increase by 1% what is being allocated through Cofina, which would result in a $200 million annual reduction in the General Fund in subsequent years. This isn't an increase in the IVU, but an additional increase to the money already allocated to Cofina. This will also allow the payment of hundreds of millions of dollars ($750 million) held back for suppliers and nonprofit organizations, the report explained.

This proposal requires legislative approval and better management of cash flow at the Treasury Department since, for the most part, the revenue of the first semester of each fiscal year would have to be reserved for debt-service payment. This potential proposal will also depend on the receptivity of potential bond buyers and credit-rating agencies.

Although Caref considered the possibility of increasing the IVU from 7% to 8%, it decided against recommending an increase if it becomes indispensable in order to issue Cofina bonds to cover the deficit. Each 1% of the IVU represents approximately $200 million a year in revenue.

"The advisory council has already submitted its report on public-private partnerships, and the only thing it does is give order and guarantee transparency in the contracting process to projects the previous administration wanted to do. This second report arrived just before the start of the legislative session. The third one, which will contain specific economic recommendations, is expected sometime in the spring, and we will be working as a team with those recommendations," Fortuño concluded. ■